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SUBJECT: CEFTA - RATIFICATION LIKELY AS GOVERNMENT PREPARES NEW
TOBACCO STRATEGY

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SUMMARY

1. (SBU) Following the initialing of the Central European Free Trade Agreement (CEFTA) in December, the Government of Serbia (GOS) is still in negotiations with various parties to minimize the adverse impact CEFTA will have on the domestic tobacco industry. Officials told econoffs that Serbia will ratify CEFTA and that finding a compromise with Croatia is unlikely due to Croatia's rigid position on this issue. The GOS is now developing a new tobacco sector strategy that aims at mitigating the negative impacts of CEFTA on domestic tobacco companies through a variety of measures. The GOS proposal appears to track closely with the approach that Philip Morris has been pushing. END SUMMARY.

SERBIA WILL RATIFY CEFTA

2. (SBU) On February 12, econoffs met with Deputy Minister Vlatko Sekulovic, of the Ministry of International Economic Relations (MIER), who is head of Serbia's CEFTA delegation. Sekulovic indicated that CEFTA is too important for Serbia not to ratify in its aspirations for EU accession. Negotiations with Croatia over Serbia's excise tax structure have not been effective as Croatia has taken a tough position against any discriminatory treatment of cigarette imports to Serbia. Sekulovic said that of the options available to Serbia at this time, developing a new tobacco strategy is not only the easiest, but also the right thing to do in upholding commitments made to investors like Philip Morris International (PMI) and British American Tobacco during privatization.

NEW TOBACCO STRATEGY

3. (SBU) In developing the strategy, Sekulovic emphasized four main objectives of the government: 1) Ratification of CEFTA, 2) increasing the quality of domestic tobacco production, 3) increasing exports of cigarettes and 4) preserving budget revenues from duties and taxes.

4. (SBU) As a result of CEFTA ratification, the excise tax system must be equalized for domestic and foreign cigarette producers. Serbia will unify the excise tax structure, requiring higher rates for domestic manufacturers and providing lower rates to foreign ones, Sekulovic said, but implementation likely will not take place until January 1, 2008, thereby affording domestic manufacturers additional time under the current excise structure. (Note: during privatization of the tobacco industry, the GOS made commitments to foreign investors of preferential excise treatment through January 1, 2010.)

5. (SBU) In order to redress domestic tobacco manufacturers' loss of

two years of preferential excise treatment, the GOS will propose modifications to the Law on Excises, the Law on Customs Tax and the Tobacco Law. Currently, domestic cigarette manufacturers must procure 50 percent of tobacco from domestic farmers. State Secretary Vesna Arsic at the Ministry of Finance told econoffs on

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February 9 that the Ministry of Agriculture conducted a recent study to review the effects of this policy. Since 2003, the study showed that the land used for tobacco production had decreased by 50 percent. Therefore, fewer farmers benefited, while cigarette producers lacked the supply to meet demand and in many cases were forced to procure poor quality product. Both Arsic and Sekulovic confirmed that they expect the GOS to propose repealing the domestic tobacco procurement obligation in the current Tobacco Law, replacing it with a premium payment system that rewards quality. This move will secure alignment with WTO and EU requirements in this area, as well.

¶16. (SBU) In order to provide domestic manufacturers with a level of protection similar to that enjoyed by manufacturers in other countries, particularly in the EU, Serbia will revise the Law on Customs Tax to increase the duty rate to 57.6 percent (EU level) on cigarettes imported from all countries, except for those countries where Serbia has concluded free trade agreements stipulating otherwise (CEFTA countries and Russia). This move will also help preserve budget revenues. Both Arsic and Sekulovic indicated that the EU will not object to this change.

¶17. (SBU) As a concession to the domestic tobacco industry, Arsic said that the GOS is considering waiving the requirement under which tobacco companies must pay RSD 1.07 per pack of cigarettes sold into the Serbian Health Fund.

¶18. (SBU) Arsic also said that the GOS also will adopt a long-term schedule for excise taxes that will provide predictability to the industry, but also reduce the ad valorem portion of the excise from

50 percent to 43 percent, to ease the impact on higher value cigarettes, another key goal of Philip Morris.

¶19. (SBU) Tobacco industry representatives are pleased with the level of cooperation demonstrated by the GOS. Eugenio Sidoli, Managing Director of DIN "Fabrika Duvana," the Serbian subsidiary of Philip Morris International (PMI), told econoffs that the GOS has actively engaged the tobacco companies and is incorporating many of PMI's suggestions into the new strategy. On another issue, the levy of excise taxes by both Serbia and Montenegro on tobacco products shipped to Montenegro, Serbia's Ministry of Finance reinterpreted tax regulations to abolish the double taxation after PMI threatened to shift production destined for Montenegro to a factory outside of Serbia.

COMMENT

¶19. Tobacco manufacturers understand the importance of CEFTA to Serbia and support Serbia's decision to ratify. However, PMI has led the industry in its advocacy efforts to ensure that the GOS mitigates any adverse impacts from CEFTA accession. It appears that the GOS has gotten the message regarding fair treatment of existing investors and is following closely industry recommendations in its proposed modifications to existing laws, although it remains to be seen whether the new government will implement the policy that the ministries are now developing.

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